No. 20095

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PETER M. ELLIOTT, as Trustee in Bankruptcy of the Estate of VAN'S MARKET, a co-partnership composed of KENNETH M. PRICE and WILLIAM R. BABINEAU, Bankrupt,

Appellant,

vs.

A. J. BUMB, as Trustee in Bankruptcy of the Estate of SECURITY CURRENCY SERVICES, LTD., Bankrupt,

and

CORPORATIONS COMMISSIONER FOR THE STATE OF CALIFORNIA,

Appellees.

APPELLANT'S OPENING BRIEF.

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APPELLANT'S OPENING BRIEF.

This is an appeal from an order of Judge Thurmond Clarke, United States District Judge for the Southern District of California, made and entered on April 9, 1965, in which he reversed, on review, an order of Referee Robert B. Powell, made and entered on January 6, 1965, which adjudged and decreed any trust created in favor of Security Currency Services, Ltd., pursuant to Sections 12300.3 and 12300.4 of the Financial Code of the State of California, to be wholly invalid against the trustee in bankruptcy of Van's Market, pursuant to Section 67(c)(2) of the Bankruptcy Act. (11 U.S.C.A. Sec. 107 (c)(2)).

I.
JURISDICTIONAL STATEMENTS.

On November 19, 1963, an involuntary petition in bankruptcy was filed against Van's Market *et al.* in the United States District Court for the Southern District of California, Central Division, and thereafter, on March 5, 1964, Van's Market, a copartnership composed of Kenneth M. Price and William R. Babineau was adjudged a bankrupt.

Pursuant to an Application by Peter M. Elliott, as trustee in bankruptcy of Van's Market, etc. [R-2], an Order to Show Cause was issued by the Referee on September 18, 1964 [R-5], and Answers were filed by A. J. Bumb, as trustee in Bankruptcy for the estate of Security Currency Services, Ltd., bankrupt, and the California Corporations Commissioner [R-81 and 84].

No oral or documentary evidence was introduced but the matter was submitted to the Referee pursuant to a written Stipulation of Facts, filed November 20, 1964 [R-109].

The Referee issued his Memorandum Opinion on December 16, 1964 [R-112], and Findings of Fact, Conclusions of Law and an Order were entered by the Referee on January 6, 1965 [R-119 and 123].

Both A. J. Bumb, as trustee for the estate of Security Currency Services, Ltd., bankrupt, as well as the California Corporations Commissioner filed petitions for review [R-7 and 16], and the Referee issued his Certificate on Review [R-26].

Hearing on review was had before the Honorable Thurmond Clarke, United States District Judge, on March 29, 1965, at which time argument was had and the matter was submitted.

On April 9, 1965, Judge Clarke entered his Order [R-79], reversing the aforesaid Order of the Referee.

Within the time allowed by law, your appellant filed a Notice of Appeal, to wit, on April 19, 1965 [R-125], and your appellant has taken the steps required by law in presenting the necessary record on the within appeal.

The jurisdiction of the Court of Appeals is invoked pursuant to Section 24 of the Bankruptcy Act (11 U.S.C.A. Sec. 47).

II.

STATEMENT OF FACTS.

The facts pertaining to the within appeal are not in dispute and, in fact, the same have been stipulated to by all parties.

An involuntary petition in bankruptcy was filed against Van's Market etc., on November 19, 1963, and thereafter, Van's Market, a copartnership composed of Kenneth M. Price and William R. Babineau, was adjudged a bankrupt on March 5, 1964. Peter M. Elliott is the duly appointed, qualified and acting trustee in bankruptcy of said Van's Market.

On October 15, 1963, Van's Market executed a general assignment for the benefit of its creditors to the Credit Managers Association of Southern California, a California corporation, and as of that date ceased to do business. Van's Market was an agent of Security Currency Services, Ltd., for the purpose of selling money orders and checks.

For the period preceding October 15, 1963, there was due from Van's Market to Security Currency Services, Ltd., the sum of $3,092.99, representing proceeds from

the sale of money orders and checks sold by Van's Market as agent for Security, and the additional sum of $16.17, reresenting fees for the sale of checks, making a total obligation due from Van's Market to Security in the sum of $3,109.16. Security honored and paid all checks or money orders from which the above proceeds arose.

Security Currency Services, Ltd. filed a petition under the terms of Chapter XI of the Bankruptcy Act on January 16, 1964, and appellee, A. J. Bumb, was appointed receiver therein. Security was later adjudged a bankrupt and said A. J. Bumb is now the duly appointed, qualified and acting trustee of the estate of Security Currency Services, Ltd., bankrupt, In Bankruptcy No. 166,114-TC in the United States District Court, Southern District of California, Central Division.

The Credit Managers Association of Southern California is presently holding the sum of $2,014.99, which represents monies which were on deposit in Van's Market's bank account prior to October 15, 1963, at Bank of America, Harbor and Palm Branch, Los Angeles, California, and which represented money orders sold by Van's Market for Security.

The difference between the aforesaid sum of $3,-109.16 and the aforementioned sum of $2,014.99 or $1,094.17 was commingled by Van's Market with its other assets which were liquidated by the Credit Managers Association of Southern California, as the assignee for benefit of creditors, and the liquidation proceeds in the sum of $2,987.56 were turned over to appellant.

The California Corporations Commissioner asserts no claim to the funds held by appellant nor to the funds

held by the aforesaid Credit Managers Association but is charged with the responsibility of enforcing the Check Seller's and Cashier's Law set forth in Sections 12000, *et seq.* of the California Financial Code.

Similarly, the said Credit Managers Association of Southern California asserts no claim to the $2,014.99 held by it but merely seeks a determination as to who they should pay, either appellant or appellee, A. J. Bumb.

In addition, on or about November 15, 1962, an agreement entitled "Agency Franchise and Trust Agreement" was executed by and between Security Currency Services, Ltd. and Van's Market [Ex. "A"].

III.

SPECIFICATION OF ERRORS.

The Order of the United States District Court, Reversing the Referee's Order [R-79] Is Erroneous in That:

(1) The Court was in error in concluding that, as a matter of law, under the facts of this case, proceeds from the sale of money orders and checks by Van's Market, as agent for Security Currency Services, Ltd., whether,

   (a) deposited to a trust account, or

   (b) commingled with assets of the bankrupt, constitute trust funds under California Financial Code, Secs. 12300.3 and 12300.4;

(2) The Court was in error in concluding, as a matter of law, that any trust created by Sections 12300.3 and 12300.4 of the California Financial

Code is not subject to the provisions of Section 67(c) of the Bankruptcy Act [11 U.S.C. § 107 (c)];

(3) The Court erred in not finding that there was no express, constructive, or resulting trust;

(4) The Court was in error in not concluding, as a matter of law, that any statutory trust created by California Financial Code Sections 12300.3 and 12300.4 should be treated the same as a statutory lien so far as bankruptcy is concerned;

(5) The Court was in error in not concluding, as a matter of law, that any such trust so created, is merely a state created priority and invalid pursuant to Section 64(a)(5) of the Bankruptcy Act;

(6) The Court was in error in reversing the order of the Referee of January 6, 1965.

IV.

SUMMARY OF ARGUMENT.

(A) Although the Bankruptcy Act Nowhere Deals Explicitly With Statutory Trusts, They Should be Treated the Same as Their Functional Equivalent, the Statutory Lien;

(1) Statutory Trusts Should be Treated the Same as Statutory Liens, so Far as Bankruptcy is Concerned;

(2) The Bankruptcy Act Voids, as Against the Trustee, Statutory Liens on Personal Property not Accompanied by Possession, Levy, Sequestration, or Distraint of Such Property;

(B) The Interest Created by Sections 12300.3 and 12300.4 of the California Financial Code is a State Created Priority, Invalid Under the Chandler Act [Title 11 U.S.C. §104(a)(5)];

(C) The Evidence Does Not Support Any Finding of an Express, Constructive or Resulting Trust;

(D) Even if the Interest Created by Financial Code Sections 12300.3 and 12300.4 Is Not Treated as a Lien, Beneficiaries of a Trust, Whether Statutory or Otherwise, Must Trace the Trust Res, Which Appellees Have Failed to Do.

V.
ARGUMENT.

Introduction.

The instant appeal asks for this Honorable Court to interpret, for the first time, the effect of bankruptcy on any interest created by California Financial Code, Sections 12300.3 and 12300.4 and to also hold for the first time that statutory trusts should be treated the same as statutory liens, so far as bankruptcy is concerned.

At the last session of the California Legislature, a bill was introduced for the repeal of these sections, however, the bill never got out of committee.

A great majority of the "agents" described in the said sections are retail merchants, *i.e.,* retail food markets, the general creditors of which had been favored under the California law, pursuant to Section 3440.1 of the California Civil Code, prior to the enactment of the sections of the Financial Code. The sections seek to

remove assets from the reach of unsecured creditors by stating that a "trust" is created to the extent of the value of money orders sold by the agent, even if the proceeds are "commingled". Presumably then, if an agent sells money orders, and the proceeds are later, for any reason, not in a trust account or even missing, the appellees take the position that a trust is created under the Financial Code on the stock in trade or even the fixtures of the agent to the exclusion of the agent's general creditors.

It is the appellant's position that this creates an interest which operates as a lien upon the physical assets of the agent, and the state legislature, by labeling this interest as a "trust", should not prevent the interest from being subject to the invalidating and subordinating provisions of the Bankruptcy Act.

The appellant also takes the position that the Financial Code sections in question create a priority in favor of one particular class of creditors, *i.e.* licensees under the code, such as Security Currency Services, Ltd. Section 64(a)(5) of the Bankruptcy Act did away with all state created priorities, but one.

It is submitted that if the so-called "trust" is upheld by this Court, the doors would be open to states creating priorities in favor of various classes of creditors, and by labeling such priorities as "trusts" the intent and purpose of Congress in enacting Section 64(a)(5) of the Bankruptcy Act would be defeated. Likewise, the section of the Bankruptcy Act dealing with liens could be circumvented by relabeling all liens created by state laws as trusts.

A. Although the Bankruptcy Act Nowhere Deals Explicitly With Statutory Trusts, They Should Be Treated the Same as Their Functional Equivalent, the Statutory Lien.

(1) Statutory Trusts Should Be Treated the Same as Statutory Liens, so Far as Bankruptcy Is Concerned.

Certainly it cannot be said that any trust created in favor of Security Currency Services, Ltd., pursuant to Section 12300.3 of the California Financial Code is anything other than a statutory trust.

Once that premise is reached, to wit, that any trust created is a statutory trust (and it is submitted that no other conclusion can be reached), then it must be determined what effect the Bankruptcy Act has upon any such statutory trust.

As stated in Volume 4, Collier on Bankruptcy, Section 67.12(2), at page 122:

> "*A statute may create or recognize an interest that is labelled a trust rather than a lien. Such a trust may nevertheless be construed functionally as equivalent to a statutory lien, subject to subordination, restriction and invalidation, in accordance with Section 67(c).* If, however, the statutory trust is analogized to an express, resulting or constructive trust, the beneficiary would be entitled to reclaim the statutory trust res without the subordination imposed by Section 67(c)" (Emphasis added).

As will be noted from the following quotation from Collier on Bankruptcy, the Bankruptcy Act nowhere deals explicitly with the rights of beneficiaries of statutory trusts. It is submitted therefore that we must be

guided by analogies and by interpretations of trusts rendered by the courts. In Volume 4, Collier on Bankruptcy, Section 67.25(a), the author goes on to say:

> "Although statutory trusts are not infrequently encountered, the Bankruptcy Act nowhere deals explicitly with the rights of beneficiaries of such trusts. Such trusts are likely to be created for the protection of the rights of laborers, materialmen, subcontractors, architects, and engineers in the moneys paid or payable to a prime contractor, or of the sovereign in respect to taxes collected or held by its collectors. In *Wickes Boiler Co. v. Godfrey-Keeler Co., Inc.,* the Court of Appeals for the Second Circuit had before it a New York statutory trust fund provision. A contractor, Godfrey-Keeler, filed a petition for an arrangement under Chapter XI. At that time, it owed approximately $1,800 to the Wickes Boiler Co., its subcontractor, and in turn had a balance of $8,800 due it from the Brooklyn Yarn Dye Company. This sum was sufficient to pay all laborers and materialmen. Although the Wickes Boiler Co. had never filed a mechanic's lien, it was held that the $8,800 balance, when received by the debtor-contractor, would become a trust fund for the benefit of creditors within the terms of the New York statute, and that the Wickes Boiler Co. was entitled to have it impressed with a trust to the extent of its claim. The court denied that there was substance to the debtor's claim that the New York statute creates a class of creditors entitled to priority in contravention of §64(a)(5) of the Bankruptcy Act. It stated in its first opinion:

'There has been no attempt to alter the priorities fixed by Section 64 in marshalling the assets of a bankrupt's estate. These priorities apply only to the estate of the bankrupt, and not to trust funds of which third parties are the beneficial owners. The question here is whether the property claimed by the subcontractor is or is not an asset of the debtor's estate'.

But on rehearing the court made this significant comment:

'It is unnecessary to discuss the effect of §67(c) of the Bankruptcy Act upon the distribution of funds in the hands of the trustee inasmuch as it does not appear that the general estate of Godfrey-Keller Co., Inc. had sufficient assets to pay the costs, expenses and wages mentioned in §64(a)(1) and (2) of the Bankruptcy Act. Cf. Note, 50 Yale L. J. 1268 . . . The petition for a rehearing is accordingly granted . . . without prejudice however to the right of the trustee, if he be so advised, to claim in the bankruptcy court that the (balance) due from Brooklyn Yarn Dye Company is subject to any priorities given under §64(a)(1) and (2), if other assets should not be available'.

"It has long been established doctrine that funds held by a bankrupt subject to an express, resulting, or constructive trust are not a part of the bankrupt's estate for distribution among his creditors but belong to the beneficiaries of such trust. The excerpt quoted from the first opinion above seems to indicate that the court was willing to put statutory trusts upon the same basis. This, however,

would be a mistake, *since the statutory trust is no more than a legislative device to protect a particular class of creditors.* In view of the elimination of all state-created priorities but one in §64(a)(5) and the avowed purpose in §67(c) to implement the policy of §64(a) by striking at statutory liens indistinguishable from priorities, there is reason for treating the statutory trust in the same way as its functional equivalent, the statutory lien, so far as bankruptcy is concerned. The excerpt quoted from the opinion on the rehearing in the Wickes Boiler case indicates a judicial willingness to consider the statutory trust in that perspective" (Emphasis added).

Perhaps it is appropriate here to discuss Volume 4 Collier on Bankruptcy Section 70.25, pages 1210-1212. This is apparently the authority which the District Court relied upon in reversing the Referee, and was also cited to the District Court by appellee, A. J. Bumb, and the cases contained in this section of Collier's were also cited to the District Court by appellee, Corporations Commissioner of the State of California.

The aforesaid passage from Collier states, beginning on page 1210:

"Statutory enactments may operate to create trusts in favor of designated persons. Recognition of such trusts, together with their incidents, has generally been regarded by the bankruptcy courts as a matter of following and applying the local law. *Matter of Heintzelman Construction Co., Inc.* (WD.N.Y. 1940) 46 Am. B.R. (N.S.) 28, 34 F.Supp. 109. Thus, under the New York Lien Law, funds derived by the trustee of a bankrupt

contractor as the avails of work done by the bankrupt upon property which had been improved in part by labor and materials furnished by certain claimants, or from the sale of property owned by the bankrupt which had been improved by labor and material furnished by such claimants, are impressed with a trust in favor of the claimants. *Albert Pick Co., Inc. v. Travis* (D.C., N.Y.), 25 Am.B.R. (N.S.) 230, 6 F.Supp. 486; *Matter of Heintzelman Construction Co., Inc.* (W.D. N.Y. 1940) 46 Am. B.R. (N.S.) 28, 34 F.Supp. 109; *Wickes Boiler Co., Inc. v. Godfrey-Keeler Co., Inc.* (C.C.A. 2d, 1940) 44 Am.B.R. (N.S.) 530, 116 F.(2d) 842, mod. on rehearing (C.C.A. 2d, 1941) 46 Am.B.R. (N.S.) 217, 121 F. (2d) 415, cert. den. (1941) 314 U.S. 686, 62 S. Ct. 297, 86 L.Ed. 549. A similar trust exists in favor of a claimant for workmen's compensation insurance premiums accruing against the bankrupt in connection with the improvement of the property. *Matter on Heintzelman Construction Co., Inc.,* supra. Likewise, it has been held that sales taxes collected under the local laws of the City of New York by a bankrupt merchant from his customers, while acting as a debtor in possession in a corporate reorganization, are held by him as trustee for and on account of the city and do not become part of his bankrupt estate when the proceedings are later transformed into ordinary bankruptcy. *Matter of E. Goldberger, Inc.* (E.D.N.Y. 1940) 46 Am.B.R. (N.S.) 35, 32 F.Supp. 615. See also *City of New York v. Rassner* (CC.A. 2d, 1942) 49 Am.B.R. (N.S.) 219, 127 F.(2d) 703 (sales tax collected by debtor

in possession pursuant to Chapter XI proceeding afterward superseded by ordinary bankruptcy). In cases where taxes, such as sales or social security taxes, are collected or withheld prior to bankruptcy under a statute making certain persons responsible for the collection or withholding, the relatonship established between the collector and the taxing authority may be either that of a taxpayer or merely that of debtor-creditor, depending upon the collector's obligation to pay over the tax irrespective of collection from others. For discussion, see §64.405, supra, under subhead 'Collector of Taxes.' If a collector is a taxpayer debtor and the taxing authority has no lien, priority of payment in the collector's bankruptcy will be determined under §64a(4); if the collector is merely a debtor (without being also the taxpayer) and the taxing authority has no lien, the United States as a tax claimant is entitled to a fifth priority under §64a(5) while the other taxing authorities are in the class of general unsecured creditors. Ibid.; ¶¶64.501, 64.502, supra. With respect to the treatment of tax liens in bankruptcy, see ¶67.24, supra. See also ¶64.02 supra, under subhead 'Priorities Distinguished from Liens,' and ¶67.20[9], supra. Occasionally, however, a statute may make a tax collector a trustee for sums collected or withheld, as exemplified by §7501 of the Internal Revenue Code on 1954. Formerly Int. Rev. Code §3661. See discussion in ¶64.405, supra, under subhead 'Collector of Taxes;' also *Matter of Frank* (S.D.N.Y. 1939) 39 Am.B.R. (N.S.) 697, 25 F. Supp. 1005; *Hercules Service Parts Corp. v. United*

States (C.A. 6th, 1953) 202 F. (2d) 938; *In re States Motors, Inc.* (E.D. Mich. 1958) 168 F. Supp. 82; *In re Airline-Arista Printing Corp.* (S.D.N.Y. 1957) 156 F. Supp. 403. In *City of Dallas v. Crippen* (C.A. 1948) 171 F. (2d) 526, Circuit Judge Waller dissented from a ruling according priority to a tax lien of the city over the claim of the United States in respect to taxes withheld from the bankrupt's employees. The dissent contended that the withheld taxes were trust funds belonging to the United States, but the majority insisted that the United States had claimed no trust fund. Neither opinion referred to Int. Rev. Code § 3661. *Taxes within Scope of Statutory Trust*— In Matter of *Tele-Tone Radio Corp.* (D.N.J. 1955) 133 F.Supp. 739, the trustee successfully resisted the Government's effort to establish a statutory trust under former §3661 in respect to a deposit by the debtor which was alleged to consist of collections by the debtor and its successor trustee of the federal excise tax imposed on manufacturers by Int. Rev. Code of 1954 § 4061 et seq. The provision for a statutory trust, however, applies only when a 'person is required to collect or withhold'. Here collection of the excise tax was not required and it was found that the tax was not collected as such from the vendees of the debtor. But before the government can recover on a trust basis, it must show that the taxes claimed were actually collected or withheld and must trace such funds according to prevailing rules in trust cases. *Matter of Independent Automobile Forwarding Corp.* (C.C.A. 2d, 1941) 45 Am.B.R. (N.S.) 230, 118 F. (2d) 537,

rev'd on other grounds sub nom. *United States v. State of New York* (1942) 315 U.S. 510, 8 Am.B.R. (N.S.) 85, 62 S. Ct. 712, 86 L.Ed. 998. The court of appeals opinion is quoted in part in ¶ 64.405, supra, under subhead 'Collector of Taxes.' See also *Matter of Frank* (S.D.N.Y. 1939) 39 Am.B.R. (N.S.) 697, 25 F.Supp. 1005; C. J. Waller's dissent in *City of Dallas v. Crippen* (C.A. 5th, 1949) 171 F. (2d) 526, 529, cited in n. 33, supra. But cf. *Hercules Service Parts Corp. v. United States* (C.A. 6th, 1953) 202 F.(2d) 938, *United States v. Sampsell* (C.A. 9th, 1951) 193 F.(2d) 154, and *In re Airline-Arista Printing Corp.* (S.D.N.Y. 1957) 156 F.Supp. 403, all cited in n. 44, infra, where the United States was relieved of the necessity of tracing."

However, let us examine, closely, the cases cited by Collier, *supra,* and which were also cited by the Corporations Commissioner to the District Court.

In the Matter of Heintzelman Construction Company, Inc., the Court held that under the provisions of the *New York Lien Law, which created a trust* in favor of the claimants who supplied labor and materials, and also in favor of a claimant for workmen's compensation insurance premiums, *against funds due to a bankrupt contractor* the trustee in bankruptcy took subject to the trust. The Court stated on page 111:

> "The funds from the improvement were a trust fund, and never were a part of the estate. They were such in the hands of the owner. The trustee obtained no equity or interest greater than that of the bankrupt".

However, in reading on, we find the following language on page 112:

> "Rather it seems that each claimant *has a lien* on the moneys now in the hands of the trustee —" (Emphasis added).

And, the Court further states, also on page 112:

> "The Referee has *properly directed the payment of expenses of administration* and application of the balance, after such payment, to the payment of the several priority claims in controversy here —" (Emphasis added).

Although it is not ascertainable from the decision the Court must have based the latter quoted holding upon Section 67(c)(1) of the Bankruptcy Act. Clause (2) of Section 67(c) had not yet been added at the time of the *Heintzelman* case.

In the *Albert Pick Co.* case, the Court likewise held that a fund in the hands of a trustee in bankruptcy was impressed with a "trust" in favor of subcontractors, materialmen and laborors, pursuant to the New York Lien Law. The Court, in that case, stated:

> "To follow the trustee's contention that the funds should be distributed among all the creditors would nullify the very purpose of the statute, which was to distribute the specific fund to a *preferred class of creditors.* There would be no purpose for the Lien Law were it not that the State intended to protect the very class that the statute outlined. If the contractor attempts to deprive the *lienors* of their rights, the Court should restrain and not help facilitate the avoidance of lawful obligations". (Emphasis Added)

The Court went on to hold that the claimants' rights "as trust creditors to the fund have *priority over the general creditors*" (Emphasis Added).

It is submitted that the decision is not clear whether the claims were allowed as a state created priority or as a lien, but it was allowed as one or the other. If allowed as a priority, of course, the case is no longer of any merit since Section 64(a)(5) of the Bankruptcy Act was enacted in 1938, and does away with state created priorities.

The decision refers to the claimants as "lienors". There is nothing in the decision to controvert a supposition that the claims were subordinated to the expenses of administration, pursuant to Section 67(c)(1) of the Bankruptcy Act, as they were in the *Heintzelman* case.

The *Wickes Boiler Co.* case cited by Collier is discussed *supra*. It is submitted that the *Goldberger* and *Rassner* cases have no application here, in that these cases involve a "trust" created by the collection of New York City sales taxes by a debtor in possession in Chapter XI proceedings, *after* institution of bankruptcy proceedings.

In short then, it is submitted that the aforesaid excerpt from Collier and the cases cited therein, which the District Court apparently relied upon in reversing the Referee (where applicable at all), actually support appellant's position.

If the courts admit that the interests in question are subject to expenses of administration, they are clearly treating the so-called "trusts" as liens and subject to the provisions of Section 67(c) of the Bankruptcy

Act, clause (1) of which subordinates non-possessory liens on personal property to the payment of expenses of administration and prior wage claims.

(2) The Bankruptcy Act Voids, as Against the Trustee, Statutory Liens on Personal Property Not Accompanied by Possession, Levy, Sequestration, or Distraint of Such Property.

If in light with the foregoing principles, as well as the general over-all purpose of the Bankruptcy Act to avoid secret liens wherever possible, this Honorable Court determines that any statutory trust in favor of the respondent, Security Currency Services, Ltd., should be treated as a statutory lien, then we must examine how a statutory lien should be treated.

Section 67(c)(2) of the Bankruptcy Act provides:

> "The provisions of subdivision (b) of this section to the contrary notwithstanding, statutory liens created or recognized by the laws of any state for debts owing to any person, including any state or any subdivision thereof, on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property, shall not be valid against the trustee: Provided, however, that so much of clause (1) of this subdivision (c) as restricts liens for wages and rent and clause (2) of this subdivision (c) shall not apply in proceedings under Chapter X of this Act, unless an order shall be entered therein directing that bankruptcy be proceeded with, or in proceedings under section 77 of this Act. The court may on due notice order so much of any lien in excess of the restricted amount under clause (1) and any lien

invalid under clause (2) of this subdivision (c) to be preserved for the benefit of the estate and, in any such event, such lien for the excess and such invalid lien, as the case may be, shall pass to the trustee".

It is submitted that we must be careful to distinguish between Section 67(c)(2) of the Bankruptcy Act and Section 67(c)(1), which latter sub-section only subordinates statutory liens to the payment of those items specified in Section 64(a)(1) and 2) of the Bankruptcy Act.

As stated in Volume 4, Collier on Bankruptcy, Section 67.281:

> "The most important change in Section 67(c) affected by the amendment of the Bankruptcy Act in 1952 was given but slight attention in the legislative reports which accompanied the measure. That change was the addition of a clause (2), invalidating as against the trustee all statutory liens created or recognized by state law on personal property not accompanied by possession, levy, sequestration or distraint. Its purpose has been explained, however, by one who undoubtedly participated in the drafting, as a further implementation of the objective of the Chandler Act 'to build up, as far as feasible and equitable, the residual fund for distribution among the general unsecured creditors'. It was further suggested that it 'should effectively check the growing trend in state statutes of labeling as 'liens' what essentially are 'priorities' and thereby seek to evade the scheme of priorities as set up in §64(a).'

"Clause (2) of §67(c), like clause (1), is not applicable to liens enforced by sale before the filing of a petition under the Act or to solvent bankrupts' estates. Every lien that falls within the sweep of clause (2) is also within the subordinating language of clause (1). Since invalidation includes subordination and restriction, liens falling within the language of both clauses (1) and (2), must be deemed to be invalidated by the latter clause. As pointed out subsequently, however, situations may arise where both clauses (1) and (2) may apply to a single statutory lien.

"It should be clear, on the other hand, that not every lien that is within clause (1) is within clause (2). The drastic treatment of invalidation under clause (2) is reserved for some only of the liens that are subject to clause (1). A comparison of the wording of the two clauses makes it evident that the following classes of liens coming within the first clause are not invalidated by the second:

(1) Statutory liens arising under federal rather than state law, including liens for taxes or debts owing the United States, on personalty unaccompanied by possession;

(2) Statutory liens arising under state law on personalty unaccompanied by possession but accompanied by levy upon or by sequestration or distraint of the property;

(3) Liens of distress for rent".

The interest created by Financial Code Sections 12300.3 and 12300.4 meets none of these definitions and should fall within the second clause of section 67(c).

Likewise, Remington in his treatise on bankruptcy in Volume 4, Section 1637.1 at page 107 states:

> "Section 67(c), prior to the 1952 amendment thereof, merely postponed such liens, where they were on personalty and 'not accompanied by possession of such property', to the priority of payment accorded to expenses of administration, certain other expenses and wage claims in limited amount by §64(a) of the Act. By one of the 1952 amendments, however, clause (2) of §67(c) is turned into a flat declaration that 'the provisions of subdivision (b) of this section to the contrary notwithstanding', statutory liens 'on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property, shall not be valid (italics supplied) against the trustee' ".

B. The Interest Created by Sections 12300.3 and 12300.4 of the California Financial Code Is a State Created Priority, Invalid Under the Chandler Act [Title 11 U.S.C. §104(a)(5)].

Appellees have cited the following California cases in support of their position, to wit:

Bank of America v. Bowden, 46 Cal. 2d 863;
People v. Cole Check Service, 175 Cal. App. 2d 777;
Allen v. Ramsey, 179 Cal. App. 2d 843.

It is submitted that nothing decided by the *Allen v. Ramsey* case has any application here and, likewise, in

the *Cole Check Service* case, the Court limited itself as follows:

> "Two questions are presented: (1) Did the Superior Court have the jurisdiction to appoint a receiver of all of the assets of the defendant corporation, and (2) did the supplemental order describe the assets subject to the receivership with sufficient particularity?"

The *Bank of America v. Bowden (supra)* decision, also does not decide how the sections in question of the Financial Code should be treated in the event of bankruptcy. The Court did hold that the code sections did create a trust and stated:

> "One of the purposes of the legislature in enacting certain provisions of that law which are here involved was to safeguard from the general creditors of the licensed check seller—the funds paid—"

Also, as will be noted from Vol. 15, No. 26, Assembly Interim Committee Reports, 1961-1963, pp. 38-45, the purpose of the legislature in enacting these sections of the Financial Code was to give priority to a certain class of persons in the event of bankruptcy by creating a statutory trust.

It is respectfully submitted that it is up to the Federal Legislature alone to enact statutes affecting bankruptcy priorities.

Prior to the Act of 1938, priorities created by state law were recognized in bankruptcy under Section 64(b)-(7). However, the Act of 1938 substituted Section 64(a)(5) in place of Section 64(b)(7) and it provides:

> "debts owing to any person, including the United States, who by the laws of the United States in

(is) entitled to priority, and rent owing to a landlord who is entitled to priority by applicable state law: Provided, however, that such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy".

As will be noted, priority is given *only* to debts entitled to priority under the *laws of the United States,* save one exception, rent owing to a landlord entitled to priority under state law.

As stated in Vol. 3 Collier on Bankruptcy §64.01 at page 2053:

> "The most extensive change in Section 64 occurred in what under the 1938 Act is the fifth and last class of prior claims—Under this clause persons entitled to priorities under state laws are no longer entitled to prior claims in bankruptcy, except in case of rent; under the corresponding clause of the 1898 Act they were. The change was made in view of supernumerous additions to priority by state legislation, often in conflict with the policy of the Bankruptcy Act".

Collier goes on to say in footnote 27 on pages 2053 and 2054:

> "Regarding this change, it was said in the Analysis of H. R. 12889, 74th Cong., 2d Sess. (1936) 201: 'We have deleted all state priorities except in the case of a landlord—'for like reasons of policy, we have excluded, as indicated, all other state priorities. The necessity for so doing is ob-

vious; many estates have been consumed, to the exclusion of creditors, by the ever-increasing classes of state priorities' ".

Section 67(b) of the Bankruptcy Act, recognizes valid, perfected liens. So then, under the general scheme of the Bankruptcy Act, unless a creditor is granted priority under a federal statute, or unless he has a valid lien, he is relegated to the position of a general unsecured creditor (with the exception, of course to security devices perfected under state laws).

It is submitted that the California legislature in enacting Financial Code Sections 12300.3 and 12300.4 is attempting to accomplish what Section 64(a)(5) of the Bankruptcy Act seeks to prevent. The subject sections accomplish the same thing as a valid lien would accomplish but by labeling it a trust, the appellees argue that it is not subject to the same invalidating provisions as affect liens.

It is therefore submitted that statutory trusts should be treated, to put it in Collier's words, "in the same way as its functional equivalent, the statutory lien, so far as bankruptcy is concerned".

In the case of *Strom v. Peikes* (2d Cir., 1941), 123 F. 2d 1003, the court was presented with the question of whether or not a bankruptcy court should give effect to a New York statute allowing a priority to wage earners. The trustee argued that the state statute was invalid in light of Section 64(a)(5) of the Bankruptcy Act and the claimant argued that she was en-

titled to a lien status under Section 67(b) of the Bankruptcy Act. The court sustained the trustee's position and stated, on page 1006:

> "Section 67, sub. c, clearly indicates that the preservation of liens under §67, sub. b, covers only liens in the traditional sense of rights attaching to specific property. Subsection c begins, 'Where not enforced by sale.' *Obviously, a right to priority of distribution is not ordinarily enforced by sale.* Furthermore, it is quite clear that the very sort of claim made in this estate was aimed at by the elimination of state laws as a means of obtaining priority under §64, sub. a (5).—
>
> —We should not open a door once closed by broadening the definition of a 'lien' beyond what §67 is meant to cover" (Emphasis added).

In the case of *City of New York v. Feiring* (1941), 313 U.S. 283, 85 L. Ed. 1333, the Supreme Court had before it the question of whether an obligation was a "tax" as defined by Section 64 of the Bankruptcy Act, which is not in point here, however, the court did state, in discussing the Bankruptcy Act:

> "Intended to be nationwide in its application, nothing in the language of §64 or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization by local law of the state's demand. Hence we look to the terms and purposes of the Bankruptcy Act as establishing the criteria upon the basis of which the priority is to be allowed".

It was stated by the court in *In re William Akers, Jr., Co., Inc.* (D.C. E. Dist. Pa., 1940), 31 F. Supp. 900:

> "The priority of claims in a bankrupt estate is determined by the Bankruptcy Act".

C. The Evidence Does Not Support Any Finding of an Express, Constructive, or Resulting Trust.

It is stated in 48 Cal. Jur. 2d *TRUSTS §11:*

> "To constitute a valid express trust, it is essential that there be (1) a trustee, (2) an estate conveyed to him, (3) a beneficiary, (4) a legal purpose, and (5) a legal term. Equity will in some cases make good the absence of a trustee, but if one of the other essentials be lacking, the trust itself must fail".

And 48 Cal. Jur. 2d, TRUSTS goes on to say at Section 16:

> "The trust res must be in existence when the trust is created".

The case of *Balian v. Balian's Market* (1941), 48 Cal. App. 2d 150 involved a situation where a father and some of his children agreed that earnings of, and property acquired by, members of the family were to be held in trust for all members of the family by the father as trustee, but, at the time of the agreement, there was no property which could be subject to the purported trust agreement save a sum of money, the property of the father, which had already been turned over to a son and was soon used in living expenses. The court held that there was no trust res, and the agreement was not enforceable in an action to impress a trust upon property subsequently acquired by members of the family and held in the name of the father and one brother.

The court in the Balian case stated on page 156:

> " 'To the creation of a trust, a trust res or subject matter is a *sine qua non* — In order for

> trusts to exist there must be an estate to vest in the trustee, and the property must be clearly and definitely pointed out' (*In re Lamb,* 61 C.A. 321)".

Appellee, A. J. Bumb, cited to the District Court the case of *Molera v. Cooper* (1916), 173 Cal. 259 for the proposition that "a mere promise to obtain money and thereupon hold it in trust does not create a trust until it is at least so far executed that the money has been obtained in accordance with the promise".

In the *Molera v. Cooper* case, it was agreed between a Mrs. Wohler and the defendant that in consideration of the extingishment of a certain promissory note by Mrs. Wohler and the release by her of all obligation of the defendant upon said note, the defendant would hold the face amount of the note, plus interest, in trust for two designated beneficiaries.

As the court said (in *Molera v. Cooper*):

> "It is not alleged that the defendant had in her possession or under her control the money owing upon said note, or that she has at any time since procured the same and devoted the same to said trust, or that she was then or has been since, solvent and able to do so".

Further the *Molera v. Cooper* decision stated in clear and unmistakable language:

> "It is clear that no trust was created by the aforesaid arrangement. There never was any property in existence which could be the subject of the trust".

It is submitted that when the court in the Molera v. *Cooper* case said that "a mere promise to obtain money and thereupon hold it in trust does not create a trust until it is at least so far executed that the money has been obtained in accordance with the promise", it was indicating that had the defendant set aside the face amount of the note at the time of the agreement, there would have been a valid trust. It did not hold that a trust could be created on property to arise in the future.

On the contrary, the view expressed in the *Balian's Market* case (*supra*) is the prevailing California view. It expressly held that the trust res *must* be in existence at the time on the purported creation of the trust.

Clearly, there was no trust *res* at the time of the "Agency Franchise and Trust Agreement".

There being no trust *res* in existence at that time, there could be no express, constructive or resulting trust and any "trust" was created by virtue of Sections 12300.3 and 12300.4 of the California Financial Code.

D. Even if the Interest Created by Financial Code Sections 12300.3 and 12300.4 Is Not Treated as a Lien, Beneficiaries of a Trust, Whether Statutory or Otherwise, Must Trace the Trust Res, Which Appellees Have Failed to Do.

The District Court's Order reversing the Referee, although not specific, necessarily must be interpreted to hold that a "trust" exists in favor of the appellee on the funds held by the Credit Managers Association of Southern California, as well as the funds in the hands of the trustee in bankruptcy which represents the proceeds from the liquidation of the now bankrupt's general assets.

The ultimate result of appellees' contention is that the appellee, A. J. Bumb, as trustee of the estate of Security Currency Services, Ltd., has a trust charge or lien on the sales proceeds of the stock in trade and fixtures of Van's Market, the allowance of which would defeat the unpaid trade creditors of Van's Market, and in this particular case would, in effect, dedicate the bankrupt estate to one creditor.

Even the Internal Revenue Code, which provides for a trust in favor of the United States for withholding taxes does not dispense with the requirement that the beneficiary trace the trust property into specific property in the hands of a trustee in bankruptcy.

Title 26 United States Code, Section 7501(a) provides:

> "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose".

In the case of *Hercules Service Parts Corp. v. United States* (6th Cir., 1953) 202 F. 2d 938, the court said, in discussing Section 7501(a) (Section 3661 under the 1939 Code):

> "It is the general rule that *a trust cannot be impressed* for the benefit of the cestui que trust *unless the trust property is identified or the corpus*

> *of the trust is traced into some specific fund* or thing into which the original trust property has passed in some form. The Congress in Section 3661, when it provided in effect that any person required to collect or withhold any internal revenue taxes is a trustee for the amount of such taxes, did not dispense with the test for the recovery of diverted trust funds. Here the diverted trust funds are not identified and no evidence exists that the assets of the debtor were augmented by the payments" (emphasis added).

However, the court did go on to hold that where the "diversion" of the "trust funds" was made *after* bankruptcy by a debtor in possession the requirement of tracing did not exist. As the court stated on page 940:

> "However, this is not a case in which the diversion took place prior to reorganization proceedings. In such case the tracing of the trust funds would still be necessary in order to justify giving priority to the beneficiary of the trust. *City of New York vs. Rassner,* 2nd. Cir., 127 F. 2d 703; *Elmer Co., Ltd. v. Kemp,* 9th Cir., 67 F. 2d 948. . . .
>
> "Since the funds were diverted by an officer acting under the authority and control of the court the obligation of tracing the trust corpus does not exist".

It is submitted, that in the instant case, since the alleged "diversion" or "commingling" took place prior to bankruptcy, the law is abundantly clear that the appellees must bear the burden of tracing the "trust" funds, *which they have not done.*

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT A. FISHER

APPENDIX.

CALIFORNIA FINANCIAL CODE §12300.3:

All funds received by a licensee or its agents from the sale of checks, drafts, money orders, or other commercial paper serving the same purpose and for the purpose of paying bills, invoices, or accounts of an obligor, equal in amount to the face value of such instruments or equal to the amount to be paid, shall constitute trust funds owned by and belonging to the person from whom they were received or a licensee who has paid the checks, drafts, money orders or other commercial paper serving the same purpose, for which the funds of such persons have been received by the agent but not transmitted to such licensee or deposited in the trust account of such licensee. If a licensee or an agent of a licensee shall commingle such funds with those of his own, all assets of such agent shall be impressed with a trust in favor of said purchaser or the licensee in an amount equal to the aggregate funds received or which should have been received by the agent from such sale. Such trust shall continue until an amount equal to said funds is separated from those of the agent and transmitted to the licensee or deposited in the trust account of licensee. An amount equal to all such trust funds shall be deposited in a bank or banks in an account or accounts in the name of the licensee designated "trust account," or by some other appropriate name indicating that the funds are not the funds of the licensee or of its officers, employees, or agents. Such funds, or, in the event of the commingling of such funds by licensee or its agent with those of the licensee or its agent, an amount of funds of such licensee or of its agent equal thereto, shall constitute trust funds as herein provided

and shall not be subject to attachment, levy of execution or sequestration by order of court except by a payee, or bona fide assignee, or bona fide holder in due course of a check, draft, or money order sold by a licensee, or except by an obligor for whom a licensee is acting as an agent in paying bills. Funds in said account, together with funds and checks on hand and in the hands of agents held for the account of the licensee, at all times shall be at least equal to the aggregate liability of the licensee on account of checks sold and bills, invoices, and accounts accepted for payment.

Nothing in this law shall be construed to prevent a purchaser, a holder in due course, the payee of a check, draft or money order sold by the licensee in the usual course of his business, or an obligor for whom the licensee is acting as an agent in paying bills of the obligor, from taking any legal action necessary to enforce any claims which said purchaser, holder in due course, payee or obligor may desire to take including the right to levy attachment or execution.

In the event a license under this law shall be suspended or terminated the licensee shall immediately deposit in said trust account an amount which with funds therein contained shall be equal to the outstanding checks sold and bills unpaid. (Added Stats. 1963, c. 1817, p. 3745, § 6.)

CALIFORNIA FINANCIAL CODE §12300.4:

Prior to such separation and transmittal to the licensee or deposit by its agent such funds received by said agent may be used by said agent for the sole purpose only of the making of change or cashing of checks in the normal course of its business. All such funds

received by said agent to the date of deposit or transmittal as required below or an amount equal to such funds must be separated from those of the agent and transmitted to, or deposited in the trust account of, the licensee not less than every third business day. If an agent owns or operates, either directly or indirectly, more than two locations for the sale of checks, drafts, money orders, or other commercial paper serving the same purpose and/or for the receipt of money for the purpose of paying bills, invoices or accounts of an obligor, and handles trust funds in any three-day period equal to or in excess of securities to be deposited as provided in Section 12223, said agent shall transmit to, or deposit in the trust account of, the licensee directly from each such location of such agent such funds not later than the end of the next business day following receipt; such funds to be in form of cash or checks cashed in the normal course of business only.

Where the total amount of such funds held by an agent does not exceed one thousand dollars ($1,000) in a calendar week, the commissioner may, in his discretion, by written order permit the agent to transmit or deposit such funds in periods in excess of 3 days but not more than 10 days.

If, after reasonable notice from licensee, an agent shall fail to transmit or deposit the funds, or an amount equal thereto, or to report to the licensee, as herein provided without just cause, or if an agent shall use any of such funds, directly or indirectly, for any purpose other than is permitted herein, licensee shall immediately terminate such agency and within five (5) days thereafter notify the commissioner in writing of the reason

for such termination, setting forth the name and a
dress of the agency location. No agent so terminat
shall be permitted to become an agent of the licens
or any other licensee except as provided in Secti
12301.4 of the Financial Code. (Added Stats. 19
c. 1817, p. 3746, §7.)